James River Cogeneration Company and Cogentrix of Virginia, Inc., Docket No. QF85-736-003

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James River Cogeneration Company and Cogentrix of Virginia, Inc., Docket No. QF85-736-003

Order Denying Application for Recertification as a Qualifying Cogeneration Facility

(Issued June 14, 1988)

Before Commissioners: Martha O. Hesse, Chairman; Anthony G. Sousa, Charles G. Stalon and Charles A. Trabandt.

On November 5, 1987, as supplemented on December 2, 1987 and April 29, 1988, James River Cogeneration Company (James River) and Cogentrix of Virginia, Inc. (Cogentrix) (collectively, Applicants) filed an application for recertification of the Allied Corporation Cogeneration Project (facility) as a qualifying cogeneration facility, based on a change in ownership of the facility. The proposed facility will be located in Hopewell, Virginia. Notice of the application was published in the *Federal Register* on November 19, 1987. [1] No protests or motions to intervene have been filed. On March 1, 1988, the Commission issued an order extending time for Commission action on the application.

The original application for certification as a qualifying cogeneration facility was filed by Cogentrix as lessee and on behalf of Signal Capital Corporation (Signal) as lessor/owner. The application was granted on February 7, 1986. [2]

On December 3, 1986, Cogentrix filed an application for recertification as a qualifying cogeneration facility to reflect a change in ownership from Signal to Cogentrix. All other characteristics of the facility remained unchanged from that reflected in the original application. The December 3, 1986 application was granted on February 11, 1987. [3]

The facility is now owned by James River, a North Carolina general partnership. Each partner, Cogentrix and Capistrano Cogeneration Company (Capistrano), owns a 50 percent interest. [4] The Applicants seek recertification to confirm that the ownership of the facility meets the criteria set forth in section 292.206 of the Commission's regulations. 18 C.F.R. §292.206 (1987). All other characteristics of the facility remain unchanged.

Issues

The James River General Partnership Agreement (Agreement) provides that profits, losses and surplus will be allocated 50 percent to Cogentrix and 50 percent to Capistrano. In addition, all tax attributes of the partnership, except depreciation, will be allocated 50 percent to Cogentrix and 50 percent to Capistrano. With respect to depreciation, the agreement provides for an unequal allocation of tax depreciation during the first five years of operation of the facility. Thereafter, tax depreciation will be allocated 50 percent to Cogentrix and 50 percent to Capistrano. Under the Agreement, Cogentrix received a lump sum payment from James River shortly after the formation of the partnership which came from amounts contributed by Capistrano through the partnership.

Two issues are presented. First, whether tax depreciation should be considered to be within the "stream of benefits." *See Ultrapower 3,* 27 FERC ¶61,094 (1984). Second, if the answer to the first question is yes, whether the ownership of the facility nevertheless satisfies the criteria set forth in section 292.206 of the regulations.

Discussion

The ownership criteria governing qualifying cogeneration facilities appear in section

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3(18)(B)(ii) of the Federal Power Act. Under that section, a qualifying facility must be:

. . . owned by a person not primarily engaged in the generation or sale of electric power (other than electric power solely from cogeneration facilities or small power production facilities).

16 U.S.C. §796(18)(B) (1982).

The regulation implementing this statutory provision states that:

> For purposes of this section, a cogeneration or small power production facility shall be considered to be owned by a person primarily engaged in the generation or sale of electric power, if more than 50 percent of the *equity interest in the facility* is held by an electric utility or utilities, or by an electric utility holding company, or companies, or any combination thereof.

18 C.F.R. §292.206(b) (1987) (emphasis added).

The Commission's regulations thus equate "ownership interest" with "equity interest." *Ultrapower 3*, 27 FERC at p. 61,183. However, the regulations do not define the term "equity interest." Here, as in *Ultrapower 3* where there was no question of control, the Commission determines that the decisive factor in determining "equity interest" is the "stream of benefits," i.e., the entitlement to venture profits, losses and surplus after return of initial capital contribution, as well as the share of control of the venture. 27 FERC at p. 61,184. Therefore, Capistrano's interest cannot exceed 50 percent of the stream of benefits if the criteria of section 292.206 are to be met.

The Commission has refined the "stream of benefits" test in cases subsequent to *Ultrapower 3.* In *Prodek/Hydro Resources Joint Venture,* 41 FERC ¶61,152 (1987) (*Prodek*), the utility partner was to be allocated 99 percent of the venture's profits, losses and credits during the first seven years of the venture, after which profits and losses were to be distributed to the parties until the amount of profits allocated to the nonutility partner equalled the amount of its allocated losses. In denying certification, the Commission found that the proposed distribution of profits and losses did not "achieve a balanced ownership of the project because it [did] not take into consideration the time value of money." *Id.* at p. 61,381.

Since the Agreement allocates all profits, losses, surplus and tax attributes other than depreciation during the first five years equally among Cogentrix and Capistrano, the first issue presented is whether the tax depreciation, which is unequally allocated to the benefit of Capistrano during the first five years, should be considered to be within the "stream of benefits."

The Applicants raise two arguments to support their contention that the Commission should not consider tax depreciation to be within the "stream of benefits."

First, the Applicants assert that while the Commission appears to have given some consideration to the unequal distribution of tax credits in *Prodek*, the Commission would have reached the same result if it had examined *only* the distribution of profits and losses over the term of the partnership. The Applicants suggest that Capistrano's entitlement to more than 50 percent of the tax depreciation during the first five years will be offset immediately by an equal reduction in its capital account, which governs recovery at liquidation. Therefore, the Applicants argue that the Commission should consider depreciation allocations as being similar to initial capital contributions, i.e., closer to debt than equity. Initial capital contributions, with recovery at liquidation, are viewed as closer to debt than to equity because such contributions do not influence management rights or distribution of profits. *See CMS Midland, Inc.,* 38 FERC ¶61,244 (1987); *Prodek*, 41 FERC at p. 61,380. Therefore, the Applicants assert that it is unnecessary to consider allocation of tax depreciation.

Second, since the Internal Revenue Code requires that an allocation of tax depreciation be immediately offset by a reduction in the allocated partner's capital account, which in turn reduces the amount of partnership assets to which the partner is entitled upon liquidation, one partner's unequal entitlement to tax depreciation is counterbalanced with the other partner's entitlement to more of the partnership assets whenever liquidation occurs.

We find neither argument to be convincing. While the Applicants are correct that our decision in *Prodek* could have been reached without consideration of the unequal allocation of tax credits during the initial seven years of the joint venture, we cannot ignore the fact that the Internal Revenue Code's provisions, whether relating to tax credits or deductions such as depreciation, reduce the partner's tax bill compared to that which would have otherwise resulted but for the tax provision. This fact is not changed by the Applicants' argument that depreciation reduces the partner's capital account and correspondingly his entitlement on liquidation. Applicants' argument does not take into account the time value of money. As such, the allocation of depreciation influences the net revenue the partner will retain each year, and we believe it is appropriate to consider these tax benefits to be within the "stream of benefits" for purpose of determining

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whether the ownership criteria of section 292.206 have been satisfied.

Since we have determined that tax depreciation must be considered in the stream of benefits test, we must determine whether the ownership arrangement nevertheless satisfies the test, i.e., that Capistrano receives no more than 50 percent of the stream of benefits in the James River venture.

The Applicants assert that Capistrano's depreciation entitlement is no more than commensurate with its relative initial cash contributions to the partnership. [5] In effect, the Applicants assert that the time-weighted value of the upfront payment of cash to Cogentrix more than offsets the time-weighted value of the benefits which Capistrano will receive due to the unequal allocation of tax depreciation during the first five years. Therefore, the Applicants assert that a balanced ownership of the project is achieved.

We disagree. Upon review of the confidential information supplied by the Applicants, our calculations indicate that, taking into consideration the time value of money, the upfront payment to Cogentrix remains approximately $392,000 below the amount required to effectuate an equal sharing of the tax depreciation benefits allocated to Capistrano in the first five years. Accordingly, we find that the Applicants have not satisfied the requirements of section 292.206 of the regulations.

The Commission orders:

(A) Applicants' request for recertification as a qualifying cogeneration facility is hereby denied.

(B) Docket No. QF85-736-003 is hereby terminated.

-- Footnotes --

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[1] 52 Fed. Reg. 44,472 (1987).

[2] *Cogentrix of Virginia, Inc. (Allied Corporation),* 34 FERC ¶62,311 (1986).

[3] *Cogentrix of Virginia, Inc. (Allied Corporation),* 38 FERC ¶62,143 (1987).

[4] Cogentrix is not an electric utility, electric utility holding company, or person owned by either. Capistrano is a wholly owned subsidiary of Mission Energy Company, which is a wholly owned subsidiary of The Mission Group, which in turn is a wholly owned subsidiary of Southern California Edison Company, an electric utility.

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[5] The Applicants have requested confidential treatment of the Agreement, as well as the information submitted on April 29, 1988. *See* 18 C.F.R. §388.112.